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After The Tokyo Summit

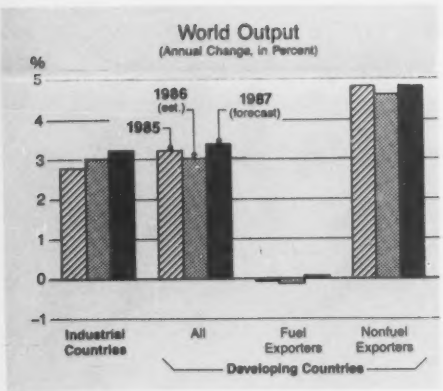
The twelfth economic summit meeting of the heads of government or state of the world's seven largest industrial countries, held in Tokyo this past May, has generally been hailed as a marked improvement over its eleven predecessors. For one thing, because of falling oil prices, the worldwide decline in interest rates, the ongoing realignment of exchange rates, the near-term outlook for the world economy was the most promising since the summits were launched in 1975.

More important, the Tokyo summit is considered an improvement over previous meetings because of the final communique's emphasis on "close and continuous coordination of economic policies among the seven summit countries." Specifically, the participants decided to form a new Group of Seven, consisting of their countries' finance ministers. The Seven would consult more closely and more frequently between the annual gatherings in order to exercise "multilateral surveillance" of each other's economies.

Output and Employment

What is the world economic outlook at the present time? It is true that lower oil prices and lower inflation and interest rates are providing the underpinning for continuing, albeit moderate, expansion in 1986 and 1987, or what the International Monetary Fund recently called "a consolidation in the pace of economic growth" (Chart 1). In the major industrial countries the demand components most likely to contribute to that expansion are consumer spending and fixed investment (Table 1).

Chart 1.



However, current projections offer little reason to anticipate another "golden age" for the world economy. In fact, the IMF's latest projections for the industrial countries differ little from those it presented a year ago or from its revised forecast of last October. The Organization for Economic Cooperation and Development, on the other hand, paints a slightly more cheerful picture in its mid-1986 outlook than it did at the end of last year. But the differences are slight and even the OECD sees the improved economic environment as adding no more than one percentage point to the industrial counties' gross national product by the middle of 1987.

One difficulty is that comparisons inevitably tend to be made with the 1960's when average annual growth in the OECD was some five percent. As Robert Lipsey of the National Bureau of Economic Research pointed out at the Conference Board's February 1986 Economic Forum, it seems to be common to take those years as the standard and consider anything less as slow growth. He feels it more appropriate to view the experience of the 1960's as an exceptional spurt, "exploiting a buildup of underutilized technologies or scientific advances that had accumulated during World War II."

A number of factors have a bearing on the near-term outlook. First, fiscal policy in the major countries is likely to be neutral, if not outright

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Table 1
Components of Real GNP Growth, Seven Summit Countries
(Percent change on previous year)

	1986	1987
Consumption expenditures	3.2	3.5
Fixed investment	5.0	4.5
Change in inventories	0.2	0.1
Government purchases	1.8	1.3
Domestic demand	3.5	3.5
Net exports	-0.4	0.0
Real GNP	3.1	3.5

less expansive. Second, a number of countries already have raised consumption taxes on gasoline and fuel oil, thus depriving consumers of the full benefit of the fall in oil prices. Third, industrial countries' exports are being affected by the reduced purchasing power of the major oil exporters. Finally, corporate profits remain well below earlier levels; according to OECD estimates, in 1985 average rates of return on capital in the major economies were barely above 1977-78 levels.

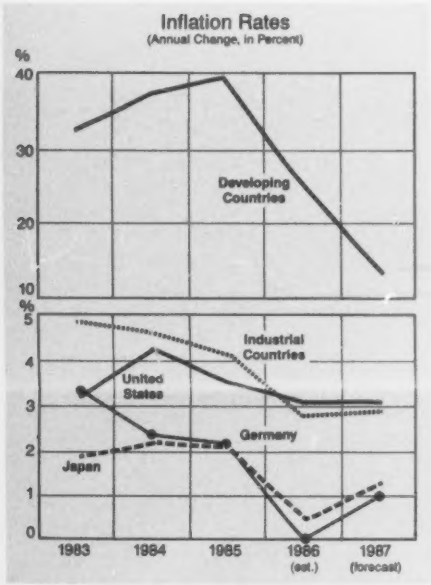
A moderate pace of world economic growth means that relatively little progress will be made in reducing the serious unemployment levels in many countries. In fact, in the absence of more rapid growth of output or of a slowing down in real wage growth employment creation is likely to remain limited.

For developing countries, growth prospects and living standards also are affected by population trends. According to recent IMF projections, per capita output in the developing world in 1986 will be virtually unchanged from the level at the beginning of the decade. This average conceals of course vast regional differences—output per head has risen considerably in Asia, but remains substantially lower than in 1980 in much of Africa and Latin America.

Inflation

In the industrial countries, inflation rates have been declining during the current expansion in economic activity and both IMF and OECD projections call for a further decline this year (Chart 2). Apart from the drop in oil prices, factors that will tend to keep inflation rates relatively low include fairly cautious monetary policies, moderate wage increases, deregulation of various markets, heightened international competition, and continued weakness in commodity prices.

Chart 2



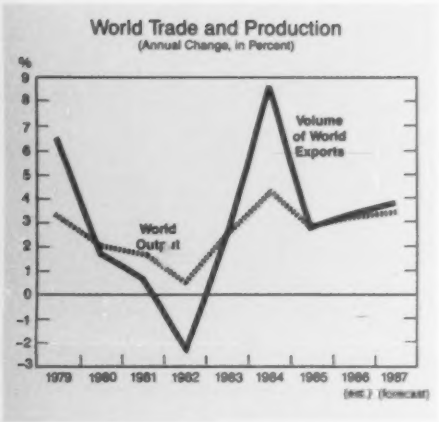
For the seven summit countries combined, the annual inflation rate during the first quarter of 1986 fell to 3.2 percent, the lowest since 1967. This contrasts with a peak of almost 14 percent in the first half of 1980. Much lower inflation rates were achieved by individual countries: In Germany, prices fell by 0.1 percent in the year through April and in Japan, they rose by 1.1 percent in the twelve months through March. Considerable progress has also been made in countries with traditionally high inflation rates. In France, the consumer price index fell from almost 6.5 percent in mid-1985 to 3 percent last March, while in Italy inflation receded to single digits in 1985 for the first time since the early 1970's.

The weighted inflation average for the developing countries—close to 40 percent in 1985—is misleading because it includes a handful of countries with triple-digit inflation. The median rate of inflation, which disregards such extreme cases, declined from 14.5 percent in 1980 to 9 percent in 1985. It is expected to remain in that range this year and fall even further in 1987.

World Trade and Payments

World trade has been one weak element in the overall economic picture. In the spring of 1985, the IMF had estimated that world production and trade would grow by 3.4 percent and 5.4 percent, respectively, last year. Yet, trade volume increased only by 2.9 percent or by no more than world output (Chart 3). Last year's weakness in trade can be attributed in part to the significant slowdown in economic activity in the industrial countries, which in turn affected adversely the exports of the developing countries. In addition, with the marked decline in oil prices the major oil producers cut back their imports more sharply than had been anticipated.

Chart 3.



Both the IMF and the GATT see last year's slowdown in trade only as a pause. In line with their projections for economic activity in the industrial countries in 1986, both organizations expect that world trade will show an increase of between three and four percent both this year and in 1987.

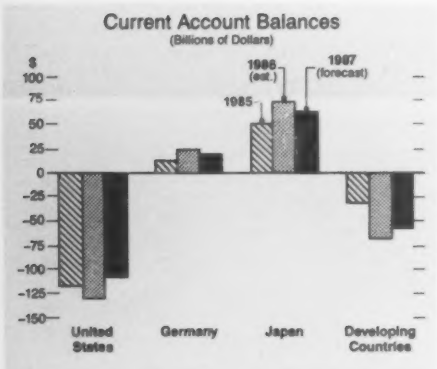
The overall payments imbalances of the major industrial countries are likely to widen further this year. Despite the narrowing of the U.S. trade deficit in April, a noticeable improvement in the U.S. trade accounts is not expected soon and the 1986 current-account deficit will even be slightly higher than in 1985. The current account surpluses of Germany and Japan will actually increase this year, reflecting the combination of lower prices for oil and other import commodities and the lower dollar (Chart 4).

At an oil price of $15 a barrel, the current-account balances of the United States, Germany and Japan would benefit by $20 billion, $18 billion, and $9 billion respectively, assuming oil imports remained unchanged from 1985 (Table 2). However, these cuts in their import bills represent a larger percent of GNP for Germany and Japan than for the United States.

Coordinating Policy

In this not very buoyant and even somewhat uncertain economic environment, the provisions of the Tokyo agreement bear close watching. In addition to setting up the Group of Seven, the participants also agreed to monitor each country's progress against a range of basic indicators, from inflation rates to growth. In case of "significant deviations" from those projections the seven countries' finance ministers and central bankers would "make their best efforts to reach an understanding on appropriate remedial measures."

Chart 4.



Better coordination of national economic policies has been a goal, either declared or unstated, of the summits since their inception. While each country's basic aims, such as satisfactory levels of growth and employment, have never been questioned, fundamental differences continue to exist on how these and related goals can best be attained. This helps explain not only the divergence in countries' actual performances, but also the inability of the summit participants to agree on what an ideal policy mix might or should be.

Even scholars and government officials have some difficulty in agreeing on what policy coordination or its less formal cousin, harmonization, really means. Thus, John Williamson of the Washington-based Institute for International Economics feels that "coordination should strive for. . .a set of mutually consistent policies on the part of individual countries which. . .collectively add up to an outcome that is satisfactory for the world as a whole." Robert Roosa, of Brown Brothers Harriman and a former Undersecretary of the Treasury, prefers the term harmonization, which he defines as "a conscious effort to work toward programs that will have harmonious rather than divisive effects in the relations among their key countries."

Making Coordination Work

Table 2
Current-Account Effect of Lower Oil Prices
($ billion)

	Per Barrel Price $15	$10
United States	-20	-28
Japan	-18	-25
Germany	-0.9	-13
France	- 7.5	-10
Italy	- 6.5	- 9

There are of course formidable difficulties in coordinating the various national policies—or even in comparing their goals and impact. There are, for instance, vast differences among countries in the conduct and targets of their monetary policies, including the various definitions of money supply. In addition, each county differs in how much attention it pays to interest-rate levels and short-term interest-rate movements, as well as in its attitude toward the relation ship between monetary policy and the exchange rate.

Similar difficulties attach to making meaningful comparisons between the major countries' fiscal policies. The most important difference among the seven summit countries concerns the relative roles of regional and local governments and of public enterprises—and hence the fiscal relations between those units and the central government. There also are major differences in the scale of government lending to both private and public enterprises, leading to differing borrowing needs by the central government and differing pressures on private financial markets.

As to the specific indicators listed in the Tokyo communique, who is to decide what particular targets are appropriate for a given country? And how can countries be brought back into line once their indicators begin flashing red? After the Williamsburg summit in 1983, Donald Regan, then Secretary of the Treasury, quipped, "If somebody is out of step, you say so."

But the communique contains no hint that any government might have to adopt a policy it would not have adopted anyway or that other countries might expect it to adopt. Moreover, both Germany and Japan already have strenuously objected to U.S. suggestions that they should stimulate their economies at this point in order to act as the world economy's locomotives, simply because their indicators (by U.S. standards, at least) were pointing in that direction. Just days before the Tokyo meeting, Germany's five leading economic research institutes urged the authorities not to bow to U.S. pressure.

It can be argued that last September's Plaza Accord to drive down the value of the dollar revealed a unique identity of interests. This was followed by "coordinated" discount rate reductions in early March (Germany, Japan and United States) and late April (Japan and United States). But in mid-1986 it is less apparent that a similar identity of interests among the major economies exists.

The best that might therefore be expected at this particular time is an awareness of the problems other countries are facing and of how they are tackling them. As Paul McCracken, a former chairman of the Council of Economic Advisers, noted recently, "Managing policies at home is presumably done a little more intelligently with some idea about the policy strategy of other governments."

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